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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1936.

No. 539

THE OHIO BELL TELEPHONE COMPANY,
Appellant,

vs.

THE PUBLIC UTILITIES COMMISSION OF OHIO,
Appellee.

APPEAL FROM THE SUPREME COURT OF OHIO.

APPELLANT'S REPLY BRIEF.

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I. PRICE TRENDS.

Appellee does not deny that in developing its price trends the Commission used (a) prices for telephone equipment furnished by manufacturers other than Western, (b) land values taken from tax rolls, (c) building cost indices taken from the Engineering News Record, (d) labor trends developed from the same source, (e) "information that the

Commission as a regulatory body must be conceded to have available" (Appellee's brief, p. 60). Neither is it denied that this information was withheld from appellant, that it was not offered in evidence, that the right to cross examine and rebut with respect to it was refused, nor that the weighting given to the various items, including the prices of Western Electric Company, was not disclosed. There was consequently a denial of due process. *Morgan* v. *United States*, 298 U. S. 468, 80 L. ed. 1288; *Crowell* v. *Benson*, 285 U. S. 22, 76 L. ed. 598.

It is claimed, first, that the Commission had the right to notice judicially the existence of the depression and to measure the changes in property values resulting therefrom by the use of information not introduced in evidence and withheld from appellant. This subject has already been considered in appellant's opening brief (pp. 31-2), and needs no further discussion here. *

Appellee's principal claim is that the Commission based its findings of value "largely • • • upon the prices of Western Electric which have not declined to the extent of general commodity prices" (Appellee's brief, p. 59); that the values found by the statutory court in the *Illinois Bell* case (*Illinois Bell Telephone Co.* v. *Gilbert*, 3 F. Supp. 595) were arrived at by a similar use of trends based on Western prices only (Appellee's brief, p. 61); and that appellant cannot complain because "It has been demonstrated that the price levels applied by the commission to the property of appellant were considerably higher than the price levels applied by the Statutory Court in the Gilbert case". (Appellee's brief, p. 70). If it be true, as claimed, that the trends represented telephone construction costs, fairly weighted, and were favorable to appellant, it would have

* The depression did not commence until October, 1929, and even this attempted justification, if otherwise valid, would not have authorized the valuation of appellant's property on the basis of judicial notice for 1926, 1927, 1928 or 1929.

been a simple matter for the Commision to disclose the information on which they were based and the manner of application thereof.

The attempted justification of the trends based on the assertion that the Commission "largely" used Western's prices is in itself a confession that the weighting given to them was not disclosed to appellant. Even appellee's counsel does not claim to know.

Thus the facts relative to the secret character of the information used to value appellant's property for 1926 to 1932, inclusive, as stated in appellant's opening brief, remain unchallenged.

Whether in fact the Commission used Western's prices "largely," or what weight it gave to them, is unknown to appellant. Appellant was deprived of its right to test the accuracy of the Commission's statement that it did use them. But if the Commission's statement is correct and imports that principal weight was given to Western's prices, then they were given weight in relation to a large portion of appellant's property to which they have no application, being applicable, as they are, to less than 30 per cent of appellant's plant.

Appellee sets out at pages 62 and 63 of its brief what purports to be a Western Electric price trend and a comparison of price trends "adopted by Statutory Court in Chicago Case and those adopted by Ohio Commission". This trend is based upon Exhibit X 13A (R. 8966), which merely shows the changes in the prices of *telephone apparatus and equipment* sold to all Bell Associate Companies. Only 55.9 per cent of Western's total sales to appellant from 1916 to 1930 consisted of telephone apparatus and equipment to which these reductions are applicable (Ex. A, 88 B, R. 8759). As the material cost is, on the average, about one-half the total cost of the plant, varying of course with the various classes of plant (R. 2290; 2304; 1086), the percentage of Western Electric telephone apparatus and equip-

ment in appellant's plant is only about 28 per cent of the total. This is further shown by the fact that in the Ohio Commission's value for June 30, 1925 (Appendix to appellant's brief, page vii), out of a total reproduction cost of $108,000,000, central office telephone equipment and station equipment aggregate less than $30,000,000. These are the only two accounts in which there will be found any substantial amount of telephone apparatus or equipment manufactured by Western. Thus the prices of Western which appellee's counsel claim were "largely" considered by the Commission in its trends, are applicable to less than 30 per cent of the entire plant.

The 70 per cent of the plant to which Western's said prices can have no application consists in part of land; buildings; lead-covered cable; copper wire; supplies, poles, and other items as to which Western is a more purchasing agent; and all labor costs.*

The intimation that a correct result has been reached and that appellant therefore cannot complain of the illegal method used is of course wholly beside the point and must fail. The correctness of the result was the very question to be tried out before the Commission and the failure to disclose the price trend information prevented any contest. Appellant was denied its right to have its case determined "with suitable opportunity through evidence and argument * * * to challenge the result". *West Ohio Gas Co.* v. *Public Utilities Commission of Ohio* (*No.* 1), 294 U. S. 63, 79 L. ed. 761). Under these circumstances appellee cannot be heard to say that perhaps appellant has not been harmed. How-

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* The prices shown in Ex. X 13 A relate to those articles of Western manufacture as to which manufacturing cost is the controlling factor, and as to which Western was enabled to make the reductions shown because of efficiency in operation and volume of business. They do not reflect the prices of lead-covered cable and copper wire, prices of which are largely controlled by the metal market, nor do they reflect the prices of items manufactured by others, though sold by Western (R. 3878; 3887-8).

ever, since the attempt is made, appellee's contentions will be considered seriatim.

Appellee's contention that the Statutory Court in the *Illinois* case in arriving at fair value considered only the prices of Western is incorrect. Neither the Company, State, nor the Statutory Court developed any Western Electric price trends or sought to apply such trends to the entire Chicago property. There, each class of property was converted from the price level of one year to that of the succeeding year by the use of labor and material cost factors, based on evidence of the changes of value in that particular class of property.

The further effort to show that the Commission reached a right result by comparing the book cost of the property less the depreciation reserve with the Commission's findings of value must fail because condemned by this Court in *West* v. *Chesapeake & Potomac Telephone Co.*, 295 U. S. 662, 79 L. ed. 1640, where this Court said at page 679, "This rough and ready approximation of value is as arbitrary as that of the Commission • • •".

Appellee's statement (Brief, p. 70) that "the price levels applied by the Commission to the property of appellant were considerably higher than the price levels applied by the Statutory Court in the Gilbert case • • •" is not correct. In the Illinois case, the value fixed for 1925 was $31,000,000 *in excess* of undepreciated book cost, as compared with a finding here of $5,000,000 *below* such cost. Not until 1931 was the value found in the Illinois case less than such cost; and the finding for 1932, of $5,000,000 below such cost, compares with a finding in the instant case, for that year, of $30,000,000 below such cost. (Table, p. 15, Appellant's opening brief).

The record, in fact, clearly shows that by its method the Commission reached a wrong result and under valued appellant's property. Findings of value ranging from

$5,000,000 below undepreciated book cost in 1925 to $30,000,000 below such cost in 1932 and $35,000,000 below such cost in 1933, (Table, p. 15, Appellant's opening brief), and less than depreciated book cost by $11,000,000 in 1932 and $15,000,000 in 1933 (Appellee's brief, p. 53) do not reflect current values. This is particularly true in the light of the evidence of Commission's witness Hagenah (R. 2117) that from 1913 to 1925 telephone construction costs in Ohio had increased from 55 to 60 per cent, most of the increase having occurred between 1916 and 1925; and that from 1921 to 1925 the average cost of plant per telephone in Ohio increased from $173 to $200.51, or an increase of 16 per cent during that period (R. 2116). Of the plant in place on June 30, 1925, $55,000,000 had been installed prior to September 20, 1921 (Wood Ex. 2, R. 8172), and much of it earlier.

The fact remains unchallenged that appellant has been required to refund more than $10,000,000 without seeing the evidence upon which the refunds were based. It is no answer that they are claimed to have been based on values determined by trends founded "largely" upon prices with which appellant was familiar. If they were based "largely" on Western's prices this but emphasizes the fact that thereby appellant's constitutional rights have been invaded, first, because Western's prices apply only to a portion of appellant's plant, and, second, because appellant was entitled to know the extent to which these prices influenced the final result. Similarly it is no answer that a correct result may perhaps have been reached, particularly in view of a record which so plainly shows that the final values reached are at wide variance with actual value. Appellant had the right to have the case determined on the basis of evidence disclosed to appellant and to challenge the results through evidence and argument.

"Convenience" No Justification for Use of Undisclosed Price Trend Information.

Appellee argues that it was impracticable for the Commission to make a company wide valuation of appellant's property for each year subsequent to 1925, and that therefore the Commission was entitled, as a matter of convenience, to use the price trend method in arriving at its findings of value for each of the years 1926 to 1933, inclusive.

This argument is based upon an entire misconception of appellant's complaint against the use of the price trend information.

Appellant's position is not that price trends, when based upon telephone material and labor costs, are not evidence of value, or that the Commission might not properly have considered price trends in arriving at values. What appellant complains of is that the price trends were used, first, as a formula and not merely as evidence of value, and, second, that the trends were based upon evidence withheld from appellant and which it was given no opportunity to examine, explain or rebut.

Surely "convenience" cannot justify the determination of a case by an arbitrary method and upon secret evidence.

The proceedings before the Commission were two-fold in character. In the *Pence* law cases appellant's obligation was to refund such portion of the bonded rate increases as the Commission should thereafter determine to be excessive. In those cases the burden of sustaining the increases clearly rested upon appellant. There is no claim that appellant did not repeatedly demand the right to discharge this burden. Indeed, the Commission concedes and the record shows that throughout the hearings appellant insisted upon the right to make this proof (R. 190).

The company wide case, on the other hand, was commenced upon the Commission's own motion and, in addition

to determining the issues with respect to Western Electric prices, license contract payments and other issues common to all of the *Pence* law cases, had for its purpose—its only purpose—the fixing of appellant's rates for the future. It was authorized by Section 614-23 of the Ohio General Code (Appellant's opening brief, Appendix p. iv), which confers upon the Commission authority to make such investigations on its own motion and fix rates for the future only after findings made. In that case (the company wide) no burden rested upon appellant to prove that its rates were just and reasonable.

Interstate Commerce Commission v. *Louisville & Nashville R. Co.*, 227 U. S. 88, 57 L. ed. 431;

State Corporation Commission of Kansas v. *Wichita Gas Co.*, 290 U. S. 561, 78 L. ed. 500.

But in any event, inasmuch as the Commission concluded only one aspect of the two-fold investigation by ordering refunds in the *Pence* law cases, and left undecided the other question, viz., that of appellant's reasonable rates for the future, the case, as determined, resolved itself into a *Pence* law case only—as to which appellant repeatedly offered to sustain the burden of proof. Having done so, it could not be prejudiced by any claimed failure to offer proof bearing upon an issue which was never decided, viz., the issue of its rates, company wide, for the future.

The record shows, however, that appellant fully cooperated with the Commission in its company wide inquiry. It furnished a detailed inventory and appraisal of its property as of June 30, 1925, and, at the Commission's request, furnished statements showing its gross and net additions by semi-annual periods thereafter. The matter of its rates for the future being still undecided by the order of January 16, 1934, appellant, notwithstanding it was under no duty to do

so, offered to make proof of the fair value of its entire intrastate property, toll and exchange, as of that year (R. 313). This offer the Commission also rejected.

In this case, the Commission, having embarked on a company wide investigation which had for its purpose the fixing of appellant's rates for the future, and having concluded that no reduction could be ordered, abandoned the company wide inquiry and attempted to relate to the *Peuce* law cases the results of its investigation in that inquiry. Its over-all values, found for the purpose of that inquiry, were arrived at by the application of the price trend percentages heretofore discussed. Admittedly there was no evidence in the record out of which such trends could have been constructed. Admittedly they were based upon evidence outside the record. Asked to disclose the information out of which the trends had been constructed, the Commission declined to permit appellant to so much as examine it, much less explain and rebut the information. How, as the result of withholding the information, can the Commission expect to avoid the implication that the information used could not stand the test of reasonable examination?

Appellee's counsel intimate that appellant's insistence upon its right to introduce evidence of the reasonableness of its rates in the bond cases came late and is invalidated because of an acquiescence in the company wide inquiry. Acquiescence in the company wide inquiry was in no sense inconsistent with the right to proceed to prove the bonded rates reasonable, but, additionally, the fact is that that right was reserved to appellant in the order instituting the company wide case and consolidating the then pending cases therewith. (R. 714.) It is further admitted in unmistakable terms by the Commission in its findings of January 16, 1934, that the company has at all times insisted upon that right (R. 190).

In 1929, in open hearing, the Commission, appellant and counsel for the State reached a definite agreement that by proceeding with the company wide case appellant was waiving none of its rights to make proof with respect to the reasonableness of its *Pence* law rates. Appellant offered to make that proof either during the progress of and as a part of the company wide investigation or at the conclusion of that case, as the Commission might desire (R. 2944-52).

II. DISALLOWANCE OF EXPENSES.

(1) Expense of Depreciation.

Appellee does not deny that the Commission's allowance for the expense of depreciation for 1925 to 1933, inclusive was $8,067,266 less than appellant's actual cost of intrastate plant retirements for that period. Appellee seeks to justify the allowances upon the four grounds urged in the Supreme Court of Ohio and set forth at page 43 of appellant's opening brief.

(a) With respect to the claim that appellant's retirement experience for the years 1925 to 1933, inclusive, was abnormal, the additional argument is now made that all or some part of that abnormality was due to the unprecedented growth of appellant's plant, beginning in 1925. Obviously appellee cannot rest solely upon the claim that there was duplicate or parallel property requiring removal, in view of the fact that its witness Hagenah testified in 1926 that there was no substantial amount of duplicate non-useful plant (Appellant's opening brief, p. 44), and the further fact that the Commission in its findings of January 16, 1934, reduced the rate base as of June 30, 1925, by $3,000,000 on account of progressive obsolescence, lack of utility, and *parallel plant facilities,* thereby limiting the amount of parallel facilities to a maximum of $3,000,000 (R. 161).

The Commission in this connection said (R. 162):

> "we should consider that the property of the Company * * * was undergoing a pronounced change in that in many cities it was the result of the combination of two companies with duplicated property. It is true that it is claimed that the combination had been completed and the property had for some time been in operation as a single unit, but it also appears from the evidence that there was a continual change going on which required the elimination of many kinds of property which still had useful life, due to the progress of the art and due also to the ever-present pressure of municipalities to rid their streets of overhead wires and poles. * * *
>
> "These matters in our judgment, point to the fact that there was a solid basis for the former judgment of the Commission, that the element of progressive obsolescence was constantly at work to lessen the value of all depreciable property beyond the one element of observed physical depreciation due to wear and tear or use and exposure as denominated by Mr. Sloan. We, therefore, feel that we must adhere to the former judgment of the Commission."

Thus the Commission has found that as a result of the unification some amount, less than $3,000,000, was represented by parallel plant facilities still in use on the day certain, and has excluded that property from the rate base. It now seeks to justify its refusal to allow appellant to reimburse itself for $8,000,000 of retirement cost on the ground that retirements were abnormal because of duplicate plant. If the Commission's annual rates of depreciation are to be sustained, the result is not only that appellant is denied the right to earn a return upon the $3,000,000 of excluded property but is also refused the right to reimburse itself for the loss incident to the retirement of that property by charges to the depreciation reserve, and additionally is required to absorb without re-

imbursement more than $5,000,000 of retirements of other property (*Cf. Pacific Gas Co. v. San Francisco*, 265 U. S. 403, 68 L. ed. 1075).

The claim that the retirements during the period in controversy were abnormal because of unprecedented growth and that therefore the Commission's rates are to be upheld is without merit. During a period of rapid growth, retirements due largely to the factor of inadequacy will be larger and more rapid than during periods of ordinary business conditions. But such necessarily larger and more rapid retirements are in no sense "abnormal."

During the period 1925 to 1930 public interest demanded that appellant construct plant to the extent required by the then current conditions. During this period the number of appellant's telephones increased by more than 40 per cent, requiring an additional investment in plant of almost $65,000,000 (R. 191; 8361). Manifestly, retirements due to inadequacy increased rapidly. No reason has been nor can be advanced why the rate-payer should not under such circumstances pay a rate sufficient to enable the company to meet its expenses, including proper expense of depreciation, and earn a fair rate of return, just as he must under ordinary business conditions.

Appellee's claim is, in short, that appellant, although required to expand its plant because of the business conditions of 1925 to 1930, is to be denied reimbursement for retirements necessarily consequent thereupon. Followed to its logical conclusion it would mean that during periods of great prosperity confiscation is permissible.

(b) While it is still claimed that the Commission gave actual consideration to appellant's retirement experience during the period 1925 to 1933, if this be so, it was forthwith rejected.

(c) With reference to the claim that appellant's depreciation reserves were inadequate, appellee approaches the question as if the Commission had found them so to be. In fact, the Commission made no such finding and there was no evidence in the record upon which such a finding could be based.*

By calculations not based upon any finding of the Commission and not in the record, appellee in its brief (pp. 102, 103) attempts to show what appellant's depreciation reserve should have been at its organization in 1921 and at the end of the period in controversy, November 30, 1933. The unsoundness of the entire argument, based upon the alleged inadequacy of depreciation reserve, is demonstrated by the fact that appellee claims that at its organization in 1921 appellant's reserve to take care of the ultimate retirement of $75,000,000 of plant should have been $14,638,670; and similarly contends that at the end of the period, 1933, appellant's reserve to take care of the ultimate retirement of $166,000,000, or twice as much of plant, should have been $14,652,468. The argument is its own refutation.

The entire argument is an afterthought of Commission's counsel. It was first advanced in the Supreme Court of Ohio. It was not made to the Commission and the Commission neither considered the question of the adequacy of reserves nor based its allowances thereupon. In point of fact the calculations now presented at pages 90, 97, 102, 103 and 104 are not, nor are they based, on any findings of the Commission. They are not in the record. They are merely calculations prepared by counsel in an effort to support the

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* Appellee admits (appellee's brief, pp. 79, 99, 106) that substantial telephone properties were taken over by appellant and recorded upon its books at depreciated value. Obviously as to these, there was no necessity for an initial reserve.

Commission's finding which was distinctly based upon another ground. Nor is it true that the Commission made any finding that appellant's annual rates of depreciation for the period 1921 to 1925 were excessive. Nor did the Commission determine the per cent condition of the property at September 20, 1921, or at any time other than June 30, 1925. The table at page 90 of Appellee's brief is not the work of the Commission nor of any witness, nor is it in the record.

The incontrovertible fact is that the Commission arrived at its allowance solely by determining the percentage of retirement cost to book cost for the period, 1921 to 1925, which it found to average annually 3.74 per cent (R. 201). This the Commission claimed to have rounded out to 4 per cent, but, as shown in appellant's opening brief (pp. 38-9) this was not in fact done. Appellant's depreciation rates should not be fixed upon the basis of a claim never presented to or considered by the Commission. *Cf. West Ohio Gas Co.* v. *Public Utilities Commission of Ohio* (No. 1), 294 U. S. 63; 79 L. ed. 761.

(d) The record shows without contradiction that the voluntary reduction of appellant's annual rates of depreciation in 1932 was due to the fact that in 1931 it had been demonstrated for the first time that appellant's growth had been temporarily arrested, as a result of which, inadequacy as a factor in determining service life had become temporarily less important (R. 3640-2; *cf.* table p. 40, appellant's opening brief). The evidence cannot be overridden by assertions of appellee's counsel.

It is submitted that the attempt to support the Commission's allowances for the annual expense of depreciation must fail. There can be no validity in an order requiring appellant to absorbe without reimbursement more than $8,000,000 of retirement losses which are known to have occurred during the period in controversy. Appellant was entitled to

an allowance for the expense of depreciation not only sufficient to parmit it to absorb these retirement losses but additionally, in view of the character of its plant and the growth which it was experiencing, to provide something additional for the ultimate retirement of its still existing plant.

(2) License Contract Costs Disallowed.

The Commission's disallowance of appellant's license contract payments is sought to be sustained almost entirely by the assertion that the Commission had the right to exercise its judgment as to whether appellant was justified in incurring the expense.

Without undertaking to discuss again the specific disallowances complained of in appellant's opening brief, appellant points out that with respect to such major disallowances as the costs incurred in the development of vacuum tubes and wireless telephony, the factual evidence altogether removes these costs from the field of judgment. This is because the uncontradicted evidence shows that the work of the department was all undertaken in direct relation to the art of telephony and has resulted in the improved vacuum tubes and the other instrumentalities set forth at page 54 of appellant's opening brief (R. 4127-9; 4139-46).

Vacuum tubes are in large use in appellant's property and have increased rapidly in number and importance of function since 1925 (R. 4134-5). All of the instrumentalities are in constant use in all parts of the Bell system (R. 4128; 4143).

There was no greater justification for the Commission's other disallowances. Administrative "judgment" cannot override undisputed proof that the license contract services were needed and used by appellant and that the payments therefor did not exceed the cost.

Neither can the Commission's disallowances be justified on the ground suggested in Appellee's brief (p. 111) that the license contract payments have been voluntarily reduced since 1928. As pointed out in appellant's opening brief (p. 51), prior to 1928 the services included the furnishing to appellant of all telephone instruments. See also *Smith* v. *Illinois Bell Telephone Co.*, 282 U. S. 133 at p. 156, 75 L. ed. 255.

III. REFUNDS ARBITRARILY ORDERED.

That the Commission fixed the amount of the refunds wholly upon the basis of gross exchange revenues; that, although ordering both toll and exchange refunds, it wholly excluded toll revenues from all consideration; and that it treated, as bonded, millions of dollars of revenue not in fact bonded, is not denied. That being so, the Commission's method of determining the amount of the refunds must necessarily fall because it bore no relation to the end sought, which was to determine how much of the total excess earnings was represented by increases in rates collected under bond. See *Dayton Power & Light Co.* v. *Public Utilities Commission of Ohio*, 292 U. S. 290, 294, 78 L. ed. 1267.

In the *Minnesota Rate Cases*, 230 U. S. 352, 57 L. ed. 1511; *Wood* v. *Vandalia R. Co.*, 231 U. S. 1, 58 L. ed. 97; *Chicago, M. & St. P. Ry. Co.* v. *Tompkins*, 176 U. S. 167, 44 L. ed. 417, comparable methods were held to result in a denial of due process.

Entirely apart from the fact that refunds could not have been arrived at by an apportionment based on gross revenues, the fact that the amount ordered refunded to toll patrons was admittedly nothing more than an accidental residue or a "left-over" (R. 3757) is sufficient to condemn the method here used.

Table of Refunds by Years.

The method by which the Commission arrived at the refunds for the several years is described at page 63 *et seq.* of appellant's opening brief.

In order, however, to show the application of the method by years, the following table has been compiled:

Year	Total gross exchange revenues (all exchanges, bond and non-bond), used as the starting point of the Commission's method (1)	Exchange revenues (including Cleveland), counted by the Commission's method as bonded (2)	Percent relation of (2) to (1) (3)
1925	$24,554,400.	$18,449,365.	75.136698%
1926	26,628,407.	23,663,276.	88.864784%
1927	28,617,757.	26,273,242.	91.807481%
1928	30,447,906.	28,027,277.	92.049931%
1929	33,431,682.	30,719,328.	91.886878%
1930	34,422,892.	31,539,782.	91.624441%
1931	33,722,537.	30,870,850.	91.543676%
1932	30,038,321.	27,478,059.	91.476682%

Year	Total excess earnings found for the year (4)	Excess earnings attributable to bonded cases found by the Commission (3) x (4) (5)	Increases collected under bond (Exchange) (6)
1925	$1,822,647.	$1,369,477.	$1,137,195.
1926	2,041,483.	1,814,159.	1,637,314.
1927	1,986,610.	1,823,857.	1,907,983.
1928	1,925,301.	1,772,238.	2,002,061.
1929	1,463,347.	1,344,624.	2,145,355.
1930	1,481,689.	1,357,589.	2,185,156.
1931	1,659,760.	1,519,405.	2,079,578.
1932	908,335.	830,915.	1,793,032.

Year	Amount ordered refunded (Exchange) (7)	Amount ordered refunded (Toll) (8)
1925	$1,137,195.	$232,282.
1926	1,637,314.	176,845.
1927	1,823,857.	Nothing
1928	1,772,238.	"
1929	1,344,624.	"
1930	1,357,589.	"
1931	1,519,405.	"
1932	830,915.	"
Total	$11,423,137.	$409,127.

Using the year 1925 for example, the table shows that for that year the total revenues of $18,449,365 from the bond exchanges amounted to 75.13 per cent of the total gross revenues of $24,554,400 from all exchanges, bond and non-bond.

That per cent was applied to the total excess earnings of $1,822,647 found by the Commission for that year, and gave $1,369,477 as the portion of the total excess earnings represented by bonded increases collected in that year. Inasmuch, however, as only $1,137,195 was collected under bond in the exchanges during that year, the balance ($232,282) not absorbable by way of exchange refunds, was arbitrarily assigned to toll.

The same process was followed for each of the other years and resulted, as stated, in the ordering of refunds in the total sum of $11,832,264 for the entire period.

Cleveland Illustration.

Appellee does not deny that by counting all of the Cleveland exchange revenues ($103,677,597) as bonded, the Commission increased the refunds by some $4,800,000 more than if only the $838,000 of actual bonded increases had been counted as bonded. It asks, however, what would have been the result had there been eliminated from the calculation "all non-bonded revenues in all protesting exchanges"? The Cleveland situation was used only by way of illustration because it reflects by far the major part of this particular error in the Commission's method. If there be eliminated from the Commission's apportionment calculation all non-bonded revenue of all protesting exchanges instead of only Cleveland's non-bonded revenue, the Commission's error, illustrated by the Cleveland situation, would obviously have been *increased*—this for the reason that each dollar eliminated from the bonded side of the Commission's calculation would have decreased the per

cent of bonded revenues to gross revenues and, correspondingly, the per cent of the total excess earnings ordered refunded for each year.

Appellant does not at all intend to convey the impression that, as the result of the Commission's method, the $4,800,000 of refunds were ordered repaid to Cleveland subscribers. (In fact only $645,000 was ordered refunded in Cleveland, notwithstanding more than $5,500,000 of refundable excess was attributed to that exchange by the Commission's method.) What appellant asserts is that by counting all of the Cleveland exchange revenue as bonded, the *total* bonded revenue ordered to be refunded was increased by that amount, and that the per cent of the total excess ordered to be repaid to the subscribers was increased proportionately.

IV. VALUATION.

(1) In General.

That appellant's property was substantially undervalued is demonstrated by the discussion relating to the Commission's use of price trends at pages 1 to 10, *supra*.

(2) Omitted Land.

Appellee seeks to justify the Commission's action in excluding from the rate base as of June 30, 1925, parcels of useful real estate purchased for central office purposes, for the following reasons.

(a) Under the Ohio statute the Commission was required to include only used and useful property and "that lands purchased for future use must be excluded" (Appellee's brief, p. 29). This contention is answered in appellant's opening brief (p. 76).

In the case of *Indianapolis Water Co.* v. *McCart et al.*, decided March 23, 1937 (since the filing of appellant's opening brief), the United States Circuit Court of Appeals for the Seventh Circuit has held that the District Court erred in excluding from the rate base property of appellant known as the "Oaklandon lands", saying:

> "It was the purpose at the time of the purchase (of the land) to construct a dam near the lower boundary line of such tract and retard the flow of water in Fall Creek and thus build a large reservoir. Appellant's engineer testified that preliminary studies had been made with respect to the proposed dam and reservoir and detailed plans completed. It seems that the advent of the depression retarded the consumption of water and this factor and others caused a slowing of the project. An examination of the evidence on this subject offers no justification for an assumption that the project has been abandoned. On the other hand it requires a finding that the property was providently purchased and in good faith and is reasonably useful for appellant's business. Under such circumstances it should have been included in the rate base."

(b) Williams and Sloan for appellant and Hagenah and Allensworth for the state all appraised the total land at the value of $3,943,467, whereas the total cost of the land as shown by appellant's books, including the excluded parcels, was only $2,693,406 (Appellee's brief, p. 29); and it is suggested rather than argued that the Commission was justified in excluding this land, because the value established by this uncontradicted evidence was in excess of book cost.

As a matter of fact the appraisals of appellant's real estate were made in almost every instance by members of local real estate boards. The appraisals were accepted by appellant's engineers and the engineers for the state (R.

130-1). In speaking of Hagenah's acceptance of these valuations, the Commission, in its tentative finding, said:

> "State's witness, Hagenah, addressed a circular letter to the City Attorneys of all the large Cities of Ohio, including every community with a population of over 25,000, asking for a report on the valuation made by the company and the standing of real estate brokers, whose judgment was the basis of the company's valuation. In practically every instance the brokers were found to be men of high standing and of good repute in their communities and the values were determined to be substantially correct and were acceptable to the cities' attorneys in the case. As a result of that investigation, witness, Hagenah, accepted the figures of the company on land value." (R. 130-1).

The Commission acted upon this undisputed evidence and accepted the values so found for all the parcels of land included in the rate base. Its rejection of the excluded parcels was solely because they were not in actual use on the date certain. Its action in this respect was in direct violation of the rule laid down in the case above cited and in those cited in appellant's opening brief, p. 75.

The table which appears as Appendix C (R. 233) to the Commission's order of January 16, 1934, and is attached hereto as Appendix C. p. vii, shows for each of the excluded parcels, the period elapsing after June 30, 1925, for which each parcel of land was excluded from the rate base.

(3) Going Value.

Appellee makes the statement that all of the items included in the "cost of establishing business," as testified to by appellant's witnesses, were in the nature of operating expenses and that, had they been actually incurred by ap-

pellant, they would have been so charged upon its books.

It is true that many of the items going to make up the cost of establishing business are of the same character as expense items and that payments therefor, if made by a company whose business already had been established, would be charged to operating expenses. Appellee, however, overlooks the fact that in arriving at the reproduction cost new of a property, these outlays are made at a time prior to the establishment of business and prior to the receipt of revenues out of which expenses can be paid. They are thus capital outlays.

This is perfectly clear from the record. The evidence distinctly shows that in arriving at the cost of establishing business the witnesses who testified were careful to exclude such costs as followed the establishment of the business and the receipt of revenues (R. 1333; 1339-48; 1350-3; 1356-7; 1360-1; 1364-6; 1759-60; 1763-70; 1772).

Thus the Commission said, in its finding of tentative value:

> "This per cent will cover those expenses necessarily incurred in the interim between the completion of the physical plant and the final attaching of its subscribers." (R. 138.)

Additionally, it is not denied that no provision for going value was made by any witness in his unit costs; that the Commission so recognized and in its tentative valuation made an allowance for going value of $3,592,040, based wholly on the evidence; that it has never retracted its finding; and that instead it has merely eliminated the item as a separate item from its final value, claiming that somewhere in the final value the allowance still exists. This, as shown in appellant's opening brief at page 77 and following, is a mathematical impossibility. Surely, under the circumstances of this case, it cannot be claimed that a rate base

$5,000,000 below the actual cost of the property is large enough to include any allowance for going value.

V. APPELLANT'S FINANCIAL EXPERIENCE.

At page 23 and 140 of appellee's brief the statement is made that upon the basis of the Commission's findings appellant's surplus at November 30, 1933, after making the refunds which have been ordered, would be $10,682,929, and its reserve for depreciation would be $14,652,468. This statement of course is based on the assumption that the Commission's findings and orders are correct in every respect. Additionally, appellee in reaching the result stated above has made an error to the prejudice of appellant in the sum of $9,201,120, as shown in the calculation and explanation attached hereto as Appendix A, p. i.

The miscalculation comes about in the main from the assumption of appellee's Counsel that appellant's original reserve when it commenced business in 1921 could have been increased by over $8,000,000 (the claimed inadequacy therein) without a corresponding reduction in surplus.

VI. COMMISSION'S RATE REDUCTION ORDER OF JANUARY 29, 1937.

Appellee directs attention to a fact not appearing in the record and not considered by the Supreme Court of Ohio, that on January 29, 1937, nearly three years after the orders here complained of, the Commission ordered a rate reduction of approximately $1,900,000, in which appellant has acquiesced.

Appellant is not now raising any question with respect to the Commission's refusal to fix rates for 1933 and thereafter. This order therefore has no bearing upon this case or any issue therein.

The Court's attention has been directed to the amount of the reduction, but not to the fact that in that order the

Commission (a) reaffirmed its earlier finding that appellant's rates in 1933, including those increased under bond, were not excessive; (b) found that the same rates for 1934, 1935, 1936, and the first three months of 1937 were not excessive; and (c) announced as a reason for the reduction that "the prospect of improving business conditions and of continuously improving efficiency in said company's operations will afford said company a reasonable opportunity to earn a fair return under reduced schedules for its service". A copy of that order, omitting only the rate schedules and the detailed discussion of the new rates, is printed as Appendix B hereto, p. iii.

Respectfully submitted,

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April 3, 1937.

APPENDIX A.

Error in Calculations on Pages 23 and 140, Appellee's Brief.

The calculations on pages 23 and 140 of appellee's brief assume that appellant's reserves in 1921 were inadequate by $8,419,041 (Appellee's brief, p. 102); and by $300,251 and $1,200,628 by reason of appellant's failure to set up adequate reserves to care for properties purchased subsequent to 1921 (Appellee's brief, pp. 102-3). These sums aggregate $9,919,920. This figure, adjusted by deducting $718,800—the difference between the disallowed depreciation for the entire company through 1933 (Appellee's brief, p. 102) and the disallowed depreciation and amortization expenses, intra state through 1932 only (Appellee's brief, pp. 141-2), becomes $9,201,120, the exact amount of the miscalculations above referred to. The fallacy in appellee's calculations is that in order to create the reserves, which it is claimed appellant should have had, it would have been necessary to secure the money from surplus.

Stated another way, appellant's book surplus at the end of the period, November 30, 1933, was $2,813,345. Its reserve was $21,999,901 or a total of $24,813,246. By restoring, as appellee has done, $2,870,218 of license contract expenses disallowed and $283,077 of Western Electric purchases attributable to the 10.2 per cent increase of 1930 and charged to expense, the figure of $27,966,541 is reached.

But in order to possess the reserve and surplus which appellee claims appellant would have at the end of the period, before making the refunds, it is essential that appellant have a reserve of $14,652,468 and a surplus of $22,515,193 (being the claimed surplus of $10,682,929 plus refunds of $11,832,264) or a grand total of reserve and surplus of $37,167,661. But all that appellant has, even including a restoration of the license contract payments disallowed and the Western Electric purchases charged to expense, is $27,966,541. The difference of $9,201,120 must come either from surplus or reserve and appellee's calculations are fallacious to that extent. This is shown by the table following:

	Depreciation Reserve	Surplus	Total
	1	2	1+2
			3
Books	$21,999,901	$2,813,345	$24,813,246
Disallowed Depreciation	*16,115,738	16,115,738	.....
Disallowed Amortization	*432,815	432,815	.....
Balance	$5,451,348	$19,361,898	$24,813,246
Disallowed Licensee payments	.....	2,870,218	2,870,218
Disallowed Western Electric Co. payments charged to expense	.....	283,077	283,077
Balance	$5,451,348	$22,515,193	$27,966,541
Refunds ordered	.....	*11,832,264	*11,832,264
Balance	$5,451,348	$10,682,929	$16,134,277
Claim of Appellee	14,652,468	10,682,929	25,335,397
Overstatement	$9,201,120	.....	$9,201,120

* Indicates red figure.

APPENDIX B.

Commission's Rate Order of January 29, 1937.

BEFORE THE

PUBLIC UTILITIES COMMISSION OF OHIO

No. 3307.—In re: Investigation and Inquiry of The Public Utilities Commission of Ohio, Upon Its Own Motion, For the Determination (a) of the Fair Value of the Property of The Ohio Bell Telephone Company, Toll and Exchange, (b) of the Just and Reasonable Rates and (c) of Reasonable Rules and Regulations For Services Furnished By Said Company to Its Patrons Throughout the State of Ohio.

FINDING AND ORDER.

The Commission, by its findings of January 16, 1934, in this cause, having found that at its rates, toll and exchange, then in effect The Ohio Bell Telephone Company had had no excess income for the year 1933, and being now of the opinion that the matter of the just and reasonable rates for the service of said company for the period of 1933 and thereafter, as well as for the future, should be disposed of as an entirety, and the public accorded the benefit of a reduction in rates at the earliest date possible, the Commission has, with the concurrence of the Attorney General of Ohio, directed said company to enter into negotiations with the Commission with respect thereto, and said company has accordingly done so.

And the Commission having made such investigation and held such hearings as by it deemed necessary and proper and being duly advised in the premises, finds that since 1932 there has been a marked increase in price levels, including those reflecting telephone property costs; that, according to information available to the Commission, the net earnings of said company upon its investment for the years

1934, 1935 and 1936 were 4.30%, 5.27% and 5.91%, respectively, or an average for the three-year period of 5.16%; that since 1933, the last year covered by said findings of January 16, 1934, there has been an increase of nearly 18% in the wages paid by said company, resulting in a total payroll increase of more than $2,500,000; that there has been an increase of nearly $1,350,000, or more than 32%, in the taxes paid by said company for the year 1936 over those of 1933; that additional taxes already imposed, including Social Security Taxes, will further increase the tax burden of said company for the year 1937 by approximately $500,000; that since 1933 said company has voluntarily made reductions and adjustments in the rates and charges for its services, both exchange and toll, amounting, in the aggregate, to $500,000 per year.

Nevertheless, and notwithstanding the foregoing facts, the Commission is of the opinion that the prospect of improving business conditions and of continuously improving efficiency in said company's operations will afford said company a reasonable opportunity to earn a fair return under reduced schedules for its service.

The Commission, therefore, coming now to consider the amount by which said rates should be reduced in the interest of the public, is of the opinion and hereby further finds after due investigation, that such reductions should be in an amount estimated at approximately $1,912,000 per annum, divided as follows:

SUMMARY OF PROPOSED REDUCTIONS.

	Estimated Per Annum Reduction
1. Adjustment in rates for exchange services amounting to a reduction of	$1,687,000
2. Adjustment in miscellaneous charges amount-to a reduction of	75,000
3. Adjustment in rates for intrastate toll services amounting to a reduction of	150,000
Total Reduction	$1,912,000

• • • • • • •

And the Commission now finding that the rates of said company in effect for the year 1933, heretofore found not to have yielded more than a fair return, are and have continued to be the just and reasonable rates for its services for the period of 1933 and thereafter up to the effective date of such new schedule, it is

ORDERED, as an entirety and not otherwise, as follows:

(1) That, conditioned that no existing rate, charge, rental or toll be thereby increased, said The Ohio Bell Telephone Company be and hereby it is notified and directed to file on or before April 1, 1937, effective April 1, 1937, schedules of rates for its services, toll and exchange, not to exceed those set forth in the new tables of principal rates, hereto attached and hereby made a part hereof by reference, as follows:

Table A—Table of Basic Exchange Rates consisting of 11 sheets numbered 1 to 11 inclusive

Table B—Table of Toll Mileage and Toll Rates consisting of 1 sheet

Table C—Table of Items Related to Exchange Rates consisting of 2 sheets

which rates the Commission hereby finds to be just and reasonable for such services, the rates contained in said new schedules to be charged by said company as the just and reasonable rates for such services from and after April 1, 1937, except that no existing rate, charge, rental or toll shall thereby be increased;

(2) That liability of said company and its sureties for the year 1933 and thereafter, whether upon their several bonds executed and in effect pursuant to Section 614-20 of the General Code of Ohio or otherwise, be and the same hereby is discharged and terminated but not for any of the years 1925 to 1932, inclusive;

(3) That liability for refunds for said years 1925 to 1932 having been fixed by order of the Commission, affirmed by the Supreme Court of Ohio, and now under review on appeal in the Supreme Court of the United States, the liability of said company and its sureties on said bonds for said years shall be in accordance with the final refund order hereto-

fore entered in this cause provided the judgment of the Supreme Court of Ohio approving said order shall be affirmed by said Supreme Court of the United States; otherwise such liability shall be in accordance with the lawful orders of the Commission subsequently made with respect thereto. Nothing herein shall prejudice the rights of either of the parties to said cause or be construed to modify, limit or otherwise affect the liability of said company for refunds for said years 1925 to 1932, inclusive;

(4) That this order shall take effect and become operative this 29th day of January, 1937. It is further ordered that a copy of this order and its accompanying tables and exhibits be forthwith served upon said The Ohio Bell Telephone Company and like copies furnished to The Honorable Herbert S. Duffy, Attorney General of Ohio, and the Mayor of each incorporated municipality in the State of Ohio wherein said company furnishes local exchange service.

The Public Utilities Commission of Ohio,
E. J. Hopple,
Chairman.
Charles F. Schaber,
R. D. Williams,
Commissioners.

[Seal.] Dated at Columbus, Ohio, this 29th day of January, 1937.

A True Copy:

David Shaw Archer,
Assistant Secretary.

* * * * * * *

APPENDIX C TO COMMISSION'S FINDINGS OF JAN. 16, 1934.

The Ohio Bell Telephone Company—Formal Case No. 3307.

RESTORATION OF LAND VALUES FOR EACH YEAR FROM 1925 TO 1933, BOTH INCLUSIVE, AND TRENDS OF SUCH VALUES

	June 30, 1925	Last 6 mos. 1925	Year 1926	Year 1927	Year 1928	Year 1929	Year 1930	Year 1931	Year 1932	11 mos. 1933
Restoration Due to Becoming Useful										
Land Values Disallowed as Not Used and Useful:										
1. At 6-30-25—Trended Value—Percent of Line 2		100.00% A	98.73% B	96.97% C	99.20% D	101.45% E	95.65% F	93.95% G	88.71% H	102.96% I
2. —Trended Value—Amount	$686,613 A	$686,613 B	$677,896 C	$657,353 D	$652,094 E	$661,549 F	$632,772 G	$594,489 H	$527,371 I	$542,981
Periods During Which Disallowed Land Values Continued to Be Not Used and Useful:										
3. Parcel No. 17—Columbus, to July, 1925	2,430									
4. " " 21—Cleveland, to June, 1926	34,609 A	34,609								
5. " " 8—Toledo, to April, 1927	159,260 A	159,260 B	157,237							
6. " " 19—Cleveland, to May, 1927	309,664 A	309,664 B	305,731							
7. " " 18—Columbus, to February, 1928	20,300 A	20,300 B	20,042 C	19,435						
8. " " 1—Springfield, to October, 1928	22,500 A	22,500 B	22,214 C	21,541						
9. " " 17—Cleveland, to December, 1929	55,200 A	55,200 B	54,499 C	52,848 D	52,425					
10. " " 3—Dayton, to Date	72,500 A	72,500 B	71,579 C	69,410 D	68,855 E	69,853 F	66,814 G	62,772 H	55,685 I	57,333
11. " " 9—Toledo, to Date	7,000 A	7,000 B	6,911 C	6,702 D	6,648 E	6,744 F	6,451 G	6,061 H	5,377 I	5,536
12. " " 1—Coshocton, to Date	3,150 A	3,150 B	3,110 C	3,016 D	2,992 E	3,035 F	2,903 G	2,727 H	2,419 I	2,491
13. Total Trended Values During Periods of Non-Use	$686,613	$684,183	$641,323	$172,952	$130,920	$79,632	$76,168	$71,560	$63,481	$65,360
14. Total Restoration Due to Becoming Useful (2-13)		2,430	36,570	484,401	521,174	581,917	556,604	522,929	463,890	477,621
Restoration Due to Reduction of Book Net Additions										
15. Parcel No. 3—Dayton, Cr. Net Add'ns in June, 1929						84,082 F	80,424 G	75,558 H	67,028 I	69,012
16. Parcel No. 9—Toledo, Cr. Net Add'ns in Sept., 1930							7,023 G	6,598 H	5,853 I	6,026
17. Parcel No. 1—Coshocton, Cr. Net Add'ns in Jan., 1933										3,513
18. Total Restoration Due to Reduction of Net Add'ns						$84,082	$87,447	$82,156	$72,881	$78,551
19. Total Restored Land Values (Line 14 plus Line 18)		$2,430	$36,570	$484,401	$521,174	$665,999	$644,051	$605,085	$536,771	$556,172

NOTE.—The composite percentages shown on Line 1 were developed by the Commission's Engineers and represent the relation of values for each current period to the preceding period and they have been applied to the basic figures bearing corresponding alphabetical designations.

The totals on Line 19 are forwarded to Appendix "B", Line 7.